

Message Text

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ACTION EUR-08

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C O N F I D E N T I A L SECTION 1 OF 2 LISBON 1623

LIMDIS

DEPT PASS TREASURY FOR SYVRUD

E.O. 11652: XGDS-3
TAGS: ECON, EFIN, PO, EAID
SUBJECT: GOP AND IMF REINITIATE DISCUSSIONS ON SECOND
TRANCHE STANDBY AGREEMENT

REF: (A) LISBON 1274 (B) LISBON 1624

SUMMARY: GOP AND IMF MISSION WHICH VISITED PORTUGAL LAST WEEK
FAILED TO REACH AGREEMENT ON MAJOR ECONOMIC POLICIES. THEY
CONCURRED IN SHIFTING THE PROGRAM TIME FRAME FROM CY 1978 TO
APRIL 78-MARCH 79. SERIOUS DIFFERENCES CONTINUE, HOWEVER,
REGRADING INTEREST RATES, EXCHANGE RATES, AND CREDIT POLICY.
CONSTANCIO WILL INVITE IMF TO RETURN TO PORTUGAL ON OR ABOUT
MARCH 13 TO RESUME FORMAL NEGOTIATIONS. END SUMMARY.

1. ECONOMIC COUNSELOR MET WITH FINANCE MINISTER CONSTANCIO
EVENING OF FRIDAY, MARCH 3, AT LATTER'S REQUEST. THIS CABLE
SUMMARIZES MAJOR POINTS OF CONVERSATION, WHICH CONSTANCIO
REQUESTED BE TRANSMITTED TO PERTINENT USG OFFICIALS.

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2. IMF MISSION LEFT LISBON THURSDAY, MARCH 2, AFTER
CONVERSATIONS WITH GOP ECONOMIC TEAM AND PRIME MINISTER
SOARES. MISSION AGREED TO CHANGE THE PROGRAM PERIOD FOR
A SECOND TRANCHE ARRANGEMENT FROM CY 1978 TO APRIL 1, 1978
- MARCH 31, 1979, BUT SIGNIFICANT DIFFERENCES EXIST ON
OTHER MAJOR ISSUES. (CURRENT ACCOUNT DEFICIT TARGET FOR
PROGRAM PERIOD REMAINS AT 800 MILLION DOLLARS; THAT FOR

CY 1978 WOULD APPROXIMATE 900 MILLION DOLLARS. PRESUMABLY OVERALL DEFICIT TARGET FOR PROGRAM PERIOD REMAINS AT 550 MILLION DOLLARS; THAT FOR CY 1978 WOULD BE ABOUT 700 MILLION DOLLARS.) FUND MISSION STATED THAT FOLLOWING ITS RETURN TO WASHINGTON IT WOULD REPORT TO IMF IDRECTORS WHO REPRESENT MAJOR COUNTRIES PARTICIPATING IN COORDINATED INTERNATIONAL LOAN PROGRAM TO PORTUGAL. WITHIN THE NEXT FEW DAYS, CONSTANCIO WILL OFFICIALLY INVITE IMF TO RESUME FORMAL NEGOTIATIONS ON MARCH 13, OR AS SOON THEREAFTER AS POSSIBLE.

3. GOP AND IMF DISCUSSED FOLLOWING MAJOR POINTS DURING VISIT:

(A) BUDGET: REVISED 1978 BUDGET, WHICH GOP WILL PRESENT TO NATIONAL ASSEMBLY BY MARCH 15, WILL VARY CONSIDERABLY FROM THE VERSION PRESENTED IN DECEMBER. REVENUES WILL BE SOME NINE BILLION ESCUDOS LOWER THAN PREVIOUSLY PROJECTED. MOREOVER, OUTLAYS WILL TEND TO BE HIGHER BECAUSE EARLIER VERSION DID NOT ADEQUATELY CONSIDER INCREASED INTEREST RATES FOR THE PUBLIC DEBT. CONSTANCIO WAS ABLE TO REDUCE PROJECTED CURRENT ACCOUNT BUDGETARY OUTLAYS BY ONLY 3 PERCENT, RATHER THAN 5 PERCENT AS HE HAD REQUESTED TWO WEEKS AGO. THUS, HE IS FORCING A REDUCTION IN CAPITAL EXPENDITURES ALSO. NEVERTHELESS, THE OVERALL DEFICIT WILL BE "SLIGHTLY" HIGHER THAN INDICATED IN THE ORIGINAL BUDGET PRESENTATION. THE FUND MISSION APPARENTLY ACCEPTED THE NEW BUDGET, THOUGH RELUCTANTLY, PARTIALLY BECAUSE IT HAD ALREADY AGREED TO THE LARGER CY 1978 EXTERNAL CURRENT ACCOUNT DEFICIT.
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(B) CREDIT: FUND RECOMMENDED CREDIT CEILING OF 120 BILLION ESCUDOS AND GOP COUNTERED BY PROPOSING 135 BILLION, I.E., THE SAME FIGURE AS LAST NOVEMBER. CONSTANCIO ADMITTED PRIVATELY THAT HE REALLY HAS NOT REACHED A DECISION ON THIS ISSUE, PARTIALLY BECAUSE HE STILL LACKS COMPLETE DATA FOR 1977. HE INDICATED THAT GOP COULD COMPROMISE ON THIS ISSUE EVEN THOUGH IT ANTICIPATES NUMEROUS BANKRUPTCIES AND HIGHER UNEMPLOYMENT RESULTING FROM THE CREDIT CONSTRAINT.

(C) INTEREST RATES: FUND REQUESTED INTEREST RATE RISE OF 7 PERCENTAGE POINTS; GOP OFFERED A 3 POINT INCREASE. ALTHOUGH WORRIED THAT HIGHER RATES WOULD DEPRESS THE LOW LEVEL OF INVESTMENTS, GOP IS PARTICULARLY CONCERNED BY WIDESPREAD POLITICAL OPPOSITION TO FURTHER RATE INCREASES. FUND REPORTEDLY PRESSED FOR 7 POINT INCREASE, RATHER THAN 5 IT HAD PROPOSED IN OCTOBER, BECAUSE HIGHER RATES ARE NEEDED TO ALLOCATE THE LIMITED AMOUNT OF AVAILABLE CREDIT. (EMBASSY COMMENT: FUND MAY HAVE A MISCONCEPTION ON THIS POINT. ACCORDING T CONSTANCIO, FUND ASSERTED THAT THE TIGHTER THE CREDIT CEILING, THE HIGHER THE INTEREST RATES MUST BE.

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C O N F I D E N T I A L SECTION 2 OF 2 LISBON 1623

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THUS, CREDIT AND INTEREST RATE POLICIES CAN BE SEEN AS ONLY ONE INSTRUMENT. INTEREST RATES WOULD, UNDER THIS INTERPRETATION, BE AN EFFICIENT ALLOCATOR OF CREDIT. THIS VIEW-POINT MAY SERVE FOR A NORMAL MARKET ECONOMY, BUT NOT FOR PORTUGAL. NUMEROUS COMPANIES, AND ESPECIALLY THE PUBLIC SECTOR, WILL TEND TO BORROW REGARDLESS OF INTEREST RATES. THEIR ALTERNATIVE WOULD BE BANKRUPTCY, WHICH IS UNACCEPTABLE TO THE GOP FOR COMPANIES LIKE TAP, THE STEEL MILL, PETROGAL, SETENAVE, ETC. THIS SITUATION PERMITS CREDIT AND INTEREST RATE POLICIES TO SERVE AS RELATED BUT DISTINCT INSTRUMENTS. THE LATTER CAN PARTIALLY COUNTERBALANCE EXCHANGE POLICY, I.E., HIGH RATES PERMITTING A RELATIVELY SMALL DEVALUATION OR LOW RATES REQUIRING A SHARP DEVALUATION. CREDIT POLICY COULD SIMULTANEOUSLY SERVE AS A RESTRAINING FACTOR ON THE DOMESTIC MARKET, WITH MUCH OF THE CREDIT ALLOCATION, EXPECIALLY FOR THE PUBLIC SECTOR, DETERMINED ADMINISTRATIVELY.) (D) EXCHANGE RATE: FUND MISSION INITIALLY EXPRESSED PREFERENCE FOR A 15 PERCENT DISCRETE DEVALUATION, BUT REPORTEDLY TERMINATED BY RECOMMENDING 10 PERCENT. CONSTANCIO IMPLIED HE AND FUND AGREED TO SUBSEQUENT CRAWL THAT WOULD PROVIDE AN CONFIDENTIAL

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AVERAGE DEVALUATION OF 21 PERCENT FOR THE YEAR. PORTUGUESE REJECTED A DISCRETE DEVALUATION, PROPOSING INSTEAD A FAST

BEGINNING CRAWL THAT WOULD DEPRECIATE THE ESCUDO BY 5 PERCENT IN THE FIRST WEEK AND THEN PERMIT A SLOWER, BUT RELATIVELY FAST, CRAWL THAT WOULD ACHIEVE THE 21 PERCENT TARGET. CONSTANCIO, WHO ADMITS THAT HE HAD EARLIER INCLINED TOWARD A SUBSTANTIAL DISCRETE DEVALUATION, NOW FEARS THE PRICE IMPACT OF A SHARP DEVALUATION. HE NOTED THAT GOP HAS ALREADY DECIDED TO RAISE ELECTRICITY 50 PERCENT, TRANSPORT 33 PERCENT, HOUSEHOLD BOTTLED GAS 40 PERCENT, AND WATER 30 PERCENT. DATA NEEDED TO DETERMINE NEW PRICES FOR "MARKET BASKET" ITEMS WILL NOT BE AVAILABLE UNTIL MARCH 7, BUT GOP FORESEES LARGE PRICE INCREASES. IN ADDITION, HE BELIEVES GOP MUST APPROVE PRIVATE SECTOR PRICE INCREASE REQUESTS PENDING SINCE 1977. THESE PRICE CHANGES, COMBINED WITH THE NEW TAX PROPOSALS, WILL PUT TREMENDOUS UPWARD PRESSURE ON THE INFLATION RATE. A SIGNIFICANT DISCRETE DEVALUATION, CONSTANCIO FORESEES, WOULD BE PASSED IMMEDIATELY TO FINAL CONSUMER PRICES, SPARKING A GALLOPING INFLATION THAT WOULD UNDERMINE GOP WAGE POLICIES.

(E) 1978 GNP: CONSTANCIO ANTICIPATES THAT THE PORTUGUESE ECONOMY WILL HAVE NO GROWTH, AND MAY EVEN DECLINE, IN 1978. GOVERNMENT CONSUMPTION, PUBLIC INVESTMENT, AND PRIVATE INCOME ARE PROGRAMMED TO FALL. PRIVATE INVESTMENT MAY DROP ALSO, PARTICULARLY BECAUSE OF TIGHT CREDIT CEILING, HIGHER INTEREST RATES AND LIMITED POSSIBILITY OF EXPORT EXPANSION. THUS, HE CONCLUDES DEMAND CANNOT POSSIBLY SUPPORT A POSITIVE GROWTH RATE.

4. DURING SEPARATE CONVERSATION MARCH 3, GERMAN AMBASSADOR TOLD ME THAT CONTANCIO HAD SUMMONED HIM THAT AFTERNOON. FINANCE MINISTER HAD PAINTED SIMILAR, THOUGH LESS DETAILED, PICTURE OF GOP/IMF MEETINGS. CONSTANCIO APPEALED
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FOR FRG UNDERSTANDING AND INFLUENCE ON IMF TO REACH REASONABLE AGREEMENT (HE DID NOT MAKE THIS SPECIFIC REQUEST TO US). CONSTANCIO REPORTEDLY STATED THAT HE COULD NOT CONCLUDE AGREEMENT ON TERMS PRESENTED BY THE FUND MISSION AND, ACCORDING TO FRG AMBASSADOR, IF PRESSED TO DO SO, CONSTANCIO SAID HE WOULD SUBMIT HIS RESIGNATION.

5. COMMENTS FOLLOW SEPTEL.
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